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Report to the Subcommittee on  
Readiness and Management Support,  
Committee on Armed Services, U.S.  
Senate

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March 2002

# DEFENSE TRADE

## Lessons to Be Learned from the Country Export Exemption



G A O

Accountability \* Integrity \* Reliability

## Report Documentation Page

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<b>Abstract</b> To control the export of defense items, the U.S. government generally requires exporters to obtain a license from the State Department. <sup>1</sup> However, a license is not required for the export of many defense items to Canada. <sup>2</sup> Currently, the Canadian exemption is the only country-specific exemption to the licensing requirement. The exemption was temporarily scaled back when unauthorized re-exports and diversions to nations of concern occurred. It was renegotiated and changes were made in an attempt to address security concerns. In May 2000, the U.S. government announced the Defense Trade Security Initiative, <sup>3</sup> which included a proposal to grant Canadian-like export licensing exemptions to other qualified countries. Since the initiative was announced, the State Department has been negotiating such exemptions with the United Kingdom and Australia. Because the exemption for Canada may serve as the model for these and other countries, you asked that we review how the exemption has been implemented and enforced and whether the experience offers any lessons learned.		
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# Contents

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<b>Letter</b>		<b>1</b>
	Results in Brief	2
	Background	3
	Exporters Are Implementing the Exemption Inconsistently	5
	Ensuring Export Compliance Is Difficult	8
	Experience with the Canadian Exemption Could Assist in Ongoing Negotiations	11
	Conclusions	13
	Recommendations for Executive Actions	14
	Agency Comments and Our Evaluation	15
	Scope and Methodology	16

---

<b>Appendix I</b>	<b>Chronology of Selected Defense Cooperation Agreements between the United States and Canada</b>	<b>19</b>
-------------------	---	-----------

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<b>Appendix II</b>	<b>Summary of Enforcement Cases That Supported the Need for Change in the Canadian Exemption</b>	<b>21</b>
--------------------	--	-----------

---

<b>Appendix III</b>	<b>Comparison of Recent Changes to the Canadian Exemption—1994, 1999, 2001</b>	<b>24</b>
---------------------	--	-----------

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<b>Appendix IV</b>	<b>Comments from the U.S. Department of State</b>	<b>27</b>
--------------------	---	-----------

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<b>Appendix V</b>	<b>Comments from the U.S. Customs Service</b>	<b>33</b>
-------------------	---	-----------

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<b>Appendix VI</b>	<b>GAO Contact and Staff Acknowledgments</b>	<b>35</b>
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<b>GAO Products on Defense Trade and Export Controls</b>		<b>36</b>
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## Tables

Table 1: Chronology of Selected Defense Cooperation Agreements between the United States and Canada	19
Table 2: Comparison of Recent Changes to the Canadian Exemption—1994, 1999, and 2001.	24



United States General Accounting Office  
Washington, DC 20548

March 29, 2002

The Honorable Daniel Akaka  
Chairman  
The Honorable James M. Inhofe  
Ranking Minority Member  
Subcommittee on Readiness  
and Management Support,  
Committee on Armed Services  
United States Senate

To control the export of defense items, the U.S. government generally requires exporters to obtain a license from the State Department.<sup>1</sup> However, a license is not required for the export of many defense items to Canada.<sup>2</sup> Currently, the Canadian exemption is the only country-specific exemption to the licensing requirement. The exemption was temporarily scaled back when unauthorized re-exports and diversions to nations of concern occurred. It was renegotiated and changes were made in an attempt to address security concerns. In May 2000, the U.S. government announced the Defense Trade Security Initiative,<sup>3</sup> which included a proposal to grant Canadian-like export licensing exemptions to other qualified countries. Since the initiative was announced, the State Department has been negotiating such exemptions with the United Kingdom and Australia. Because the exemption for Canada may serve as the model for these and other countries, you asked that we review how the exemption has been implemented and enforced and whether the experience offers any lessons learned.

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<sup>1</sup> Under the authority of the Arms Export Control Act (22 U.S.C. secs. 2751 et seq), the State Department administers the International Traffic in Arms Regulations that govern the export and temporary import of defense articles and services. The regulations identify the defense articles and services that are controlled on the U.S. Munitions List (22 C.F.R., secs. 120-130).

<sup>2</sup> The State Department is authorized to regulate commercial defense trade under the Arms Export Control Act, including exemptions to licensing requirements. State's regulations allow many unclassified defense articles, such as artillery projectors and military vehicles, and some defense services, to be exported to Canada without a license. While these items are exempt from licensing requirements, they are still subject to the act.

<sup>3</sup> For more information on the Defense Trade Security Initiative, see U.S. General Accounting Office, *Defense Trade: Analysis of Support for Recent Initiatives*, GAO/NSIAD-00-191 (Washington, D.C.: Aug. 31, 2000).

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## Results in Brief

Exporters in some instances have been implementing the Canadian exemption inconsistently. For example, some items, such as smokeless ammunition powder and technical data, are being exported using the exemption by some exporters while others are applying for licenses. Moreover, some exporters are interpreting reporting requirements about the use of the exemption differently. While the State Department has issued some guidance to assist exporters in interpreting and complying with the regulations, it has in some cases given inconsistent answers to exporters and U.S. Customs Service officials when questions were raised about particular situations.

The U.S. government has some mechanisms in place to help reduce the risk of defense items being inappropriately exported, but there are limitations associated with them. The State Department encourages exporters to voluntarily disclose violations and develop compliance programs, but primarily relies on U.S. Customs as the chief enforcer. U.S. Customs examines export documentation, performs physical inspections of items being exported, and investigates potential export violations. However, export documentation is not always complete or submitted, inspections of shipments are limited, and investigations of potential violations are time-consuming and difficult to prosecute. U.S. Customs officials attributed these and other enforcement weaknesses largely to a lack of information and resources, including inspectors to staff ports. In addition, there are competing demands on the agency, which include the prevention of terrorism, and the interdiction of illicit drugs, illegal currency, and stolen vehicles.

The experience with the Canadian exemption shows that three areas need to be addressed when negotiating and executing license exemptions with other countries. First, there needs to be upfront agreement on such issues as what items are to be controlled, who can have access to controlled items, and how to control these items through each country's respective export laws and regulations. Second, the U.S. government needs to monitor agreements to assess their effectiveness and ensure that unanticipated problems have not arisen. Third, enforcement mechanisms need to be in place to monitor exporters' compliance with the exemption and enable prosecution of violators.

We are making recommendations to the State Department to review its guidance for exporters and develop lessons learned from the Canadian exemption and to U.S. Customs to assess whether additional actions can be taken to strengthen export enforcement activities. In commenting on a draft of this report, the State Department generally concurred with our

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assessment that under the exemption the compliance and enforcement process primarily relies on the exporters' actions. State said it would continue to review its guidance and training programs and work closely with U.S. law enforcement agencies to assess lessons learned from the exemption. Customs concurred with the recommendations and will take appropriate actions by December 31, 2002.

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## Background

Under the authority of the Arms Export Control Act, State requires exporters to obtain licenses for defense exports unless an exemption applies. State has long exempted the export of many unclassified defense items to Canada without prior department approval. While these items are exempt from licensing requirements, they are still subject to the provisions of the Arms Export Control Act. Exporters who use the exemption and violate any provisions of the Act are subject to fines, penalties, or imprisonment, if convicted. State requires exporters to register with its Office of Defense Trade Controls; determine whether the articles or services they are exporting are covered by the exemption; in most cases, obtain written documentation stating that exports are to be used for a permitted purpose; and inform the recipient that items are not to be re-exported without prior authorization from State.

The Canadian exemption, first codified in 1954,<sup>4</sup> grew out of the unique geographic relationship and strong economic trading partnership between the United States and Canada and their mutual interest in the defense of North America. The two countries share the world's longest unfortified border. They are also each other's largest trading partner. The countries are committed to maintaining a strong integrated North American defense industrial base to help fulfill their defense and security responsibilities to the North Atlantic Treaty Organization and the North American Aerospace Defense Agreement, as well as for common defense of national territories. Appendix I provides a chronology of selected defense and economic agreements between the United States and Canada since 1940.

The Canadian exemption has evolved since inception in terms of scope. For example, earlier versions allowed the export and import of arms, ammunition, and implements of war, and the export of unclassified

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<sup>4</sup> 22 CFR sec. 75.36, effective January 1, 1954. This was the first time that chapter 1 of Title 22, "Foreign Relations" stated that shipments to Canada were exempt from licensing requirements.



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technical data without a license. Later versions changed the coverage to include defense services and increased the types of items requiring a license.

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## Enforcement Concerns Led to Negotiations about the Exemption

In April 1999, State revised its regulations to clarify when the exemption could be used and limited the defense items that could be exported under the exemption.<sup>5</sup> State took this action based on its analysis that exports were being re-exported from Canada to countries of concern without U.S. government approval and that controls over arms and ammunition transfers needed strengthening.<sup>6</sup> Nineteen criminal investigations and seizure cases related to the Canadian exemption were identified, including 3 diversions to China, Iran, and Pakistan and 16 attempted diversions to these and other nations of concern or technical regulatory violations. For example, a major U.S. defense company exported U.S.-controlled communication equipment to its Canadian facility under the exemption and then re-exported the equipment to Pakistan without U.S. government approval. In another case, an Iranian intelligence group established a company in Canada and was accused of attempting to use the exemption to acquire U.S.-controlled components for the Hawk missile system. Appendix II summarizes these and other cases.

In addition, State received 23 voluntary disclosures<sup>7</sup> from exporters who inappropriately used the Canadian exemption. For example, in a few instances, exporters admitted providing technical manuals and software engineering support without obtaining State approval. State consulted with the Department of Defense about these cases and indicated that had these exporters submitted the appropriate license applications, they would have likely been denied. In another instance, an exporter submitted a voluntary disclosure after being contacted by law enforcement officials. In this case, the U.S. exporter was ineligible to export because the firm was debarred and under criminal investigation for diversions of military equipment to Iran and other locations.

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<sup>5</sup> As a result of the April 1999 changes, numerous items—such as spacecraft and missiles—previously exported under the exemption required an export license.

<sup>6</sup> At the 1998 Summit of the Americas, the United States, Canada, and other countries agreed to strengthen controls over arms and ammunition transfers to better protect the hemisphere's common security. As part of this effort, State reviewed its regulations to ensure that firearms and ammunition were subject to licensing requirements.

<sup>7</sup> Most of these voluntary disclosures were reported to State after the April 1999 revision to the Canadian exemption.

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In response to export concerns identified by State, the U.S. and Canadian governments negotiated changes to their respective export control systems. The Canadian government changed its export control laws and regulations to cover all items currently controlled on the U.S. Munitions List,<sup>8</sup> established a registration system in April 2001 for persons and entities in Canada eligible to receive U.S.-controlled items under the exemption, and required U.S. government approval for re-export of U.S. controlled items from Canada or transfer of these items within Canada. In turn, State again revised the Canadian exemption effective May 30, 2001. This revision in general broadened the exemption to cover temporary imports of unclassified defense items, some defense services, and some additional items, but continued to exclude other items such as Missile Technology Control Regime<sup>9</sup> items. Since the conclusion of the negotiations, the U.S. and Canadian governments have met and continue to exchange information on enforcement and border security issues not fully addressed during the negotiations.

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## Exporters Are Implementing the Exemption Inconsistently

We found instances where exporters have been implementing the Canadian exemption inconsistently. Some items, such as technical data and smokeless ammunition powder, are being exported under the exemption by some exporters and not by others. These inconsistencies may result in the same item being licensed by State in some instances and not licensed in others, which may put some exporters at a disadvantage and lessen government oversight of exports.

For example, exporters followed different processes when they exported technical data. Before April 1999, some exported technical data under the exemption for offshore procurement<sup>10</sup> activities, based on their interpretation of the regulations.<sup>11</sup> However, State officials said that

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<sup>8</sup> The U.S. Munitions List identifies the defense articles, services, and related technical data controlled by State.

<sup>9</sup> The Missile Technology Control Regime was established to limit the proliferation of rocket and unmanned air vehicle systems capable of delivering nuclear, biological, and chemical weapons of mass destruction and their associated equipment and technology.

<sup>10</sup> An offshore procurement occurs when a U.S. company transfers unclassified technical data to a foreign company that has indigenous capability to produce the defense item outside the United States. After the foreign company produces the defense item, it is returned to the United States.

<sup>11</sup> 22 CFR sec. 124.13 (e).

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exporters were required to obtain approval before they could export the data to Canada. In April 1999, State revised the regulations to clarify that the export of technical data for offshore procurement activity requires a license. After this regulatory revision, a number of companies or their subsidiaries voluntarily disclosed to State that they had inappropriately exported technical data or defense services for offshore procurement and other activities using the exemption. Since that time, some exporters said they were unclear about when they could export technical data and defense services under the May 2001 revised exemption because the language in the regulations was subject to interpretation. For example, we were told that design data under the new exemption was broadly defined, and in some instances has been interpreted as either subject to the exemption or requiring a license. Appendix III highlights the complexities of the regulatory language and major changes made to the Canadian exemption in recent years.

Some exporters have been interpreting the May 2001 reporting requirements differently. This, in turn, can decrease the government's visibility over sensitive exports. For example, exporters using the Canadian exemption are now required by the International Traffic in Arms Regulations to provide State "a semi-annual report of all their on-going activities authorized under this section."<sup>12</sup> Two exporters interpreted the phrase "under this section" to mean that the requirement solely pertained to defense services because it fell under the paragraph of the regulations entitled "Defense services exemption." These exporters, therefore, reported activities exclusively involving defense services. Another interpreted the language to refer to all activities occurring under the Canadian exemption, including those related to defense articles and technical data, as well as defense services. When we discussed this matter with State officials, they said that the second interpretation was correct and that the report should encompass all activities and not just defense services.

Some exporters also said they were unclear about certification requirements. The regulations require exporters to obtain written certification from Canadian companies that "the technical data and defense service being exported" will be used only for a specified activity.<sup>13</sup> Some exporters said they obtain this certification when exporting defense

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<sup>12</sup> 22 CFR sec. 126.5 (c)(5).

<sup>13</sup> 22 CFR sec. 126.5 (c)(3).

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articles in addition to technical data and defense services, following preface language in the *Federal Register* notice that changed the regulation in May 2001. One company we spoke with said that it only obtains this certification for defense services. Another company noted that when it tried to get a Canadian company to fill out the certification for a defense article being exported to Canada, the Canadian government told the company that only the regulations are legally binding, and certifications should be provided only for defense services and technical data. State officials said that this interpretation was correct, and the certification only needed to be obtained for defense services and technical data. It is important that exporters correctly interpret these requirements, since the certifications enable exporters to document their compliance with regulations.

The effectiveness of the process depends on the exporters making the right decisions when interpreting regulations. However, State has an important role to play in responding to inquiries about exports. In some instances, we found that State provided inconsistent answers in situations where exporters or U.S. Customs officials responsible for enforcing export regulations raised questions to State about particular situations. For example:

- One exporter who had been shipping smokeless ammunition powder using the exemption was stopped by U.S. Customs for inspection on several occasions. Each time, U.S. Customs asked State if the exemption could be used. The first two times, State said yes, but on a subsequent occasion, it determined the powder was a Missile Technology Control Regime item and required an export license. This exporter has since obtained numerous licenses for this item. Another exporter shipping the same type of powder to Canada was also stopped by U.S. Customs for inspection. One time, State told U.S. Customs that the powder required a license and another time said the item was not a Missile Technology Control Regime item and was, therefore, exempt.<sup>14</sup>
- One exporter had planned to temporarily import aerial target aircraft for North Atlantic Treaty Organization (NATO) ongoing training exercises that were being conducted in the United States and informed U.S. Customs in

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<sup>14</sup> Questions regarding smokeless powder represented about 5 percent of Customs' referrals to State involving exports to Canada between April 12, 1999, and December 31, 2000.

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advance that it was going to do this under the exemption. Under the changes made to the exemption in May 2001, such items are allowed to be imported temporarily. However, in this case, State denied the use of the exemption. State officials acknowledged this mistake to U.S. Customs, and told us that it occurred inadvertently, immediately after the exemption change. Nevertheless, at the time, the exporter cancelled its plans, which in turn, led to the cancellation of the remaining NATO training exercises.

An exemption places the burden of proper implementation on exporters. Nevertheless, exporters said they needed guidance from State to assist them through the process of deciding what to export and what not to export under the exemption, as well as what activities to report. State officials said that exporters are to rely on the regulations as their guide. However, State has recently provided additional guidance through a question-and-answer guide the department prepared with industry to answer common questions about the May 2001 revisions to the exemption. This guidance answers some questions but does not lay out specific, clear criteria for deciding what is allowable under the exemption.<sup>15</sup> State has also provided outreach in conjunction with the Canadian government on changes associated with the Canadian exemption and regularly sponsors additional training through the Society for International Affairs.<sup>16</sup> In March 2002, State began an in-house training program on export licenses and agreements. Further, State issues advisory opinions on specific exports when requested by the exporter,<sup>17</sup> but such opinions are specific to a particular export and are revocable. Clear and commonly understood guidance may help State and U.S. Customs officials answer questions that surface during inspections.

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## Ensuring Export Compliance Is Difficult

Although an item may be exempt from State review and approval, it is still subject to U.S. export control law. Under an exemption, the burden for reviewing the legitimacy of the transaction shifts from State to the exporter. Therefore, a large part of the compliance and enforcement process under the Canadian exemption relies on the actions of exporters. While the U.S. government has some mechanisms in place to ensure that

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<sup>15</sup> State previously prepared guidelines to help exporters determine licensing requirements for Canada, in conjunction with the regulations, but these guidelines do not reflect the May 2001 revision.

<sup>16</sup> The Society for International Affairs training covers various topics on export licensing and compliance processes.

<sup>17</sup> 22 CFR sec. 126.9.

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exporters are ultimately complying with export law and regulations, the government faces limitations in using these mechanisms. For example, export documentation is not always submitted or complete, border inspections are limited, and violations are difficult to prosecute. U.S. Customs officials cite other priorities and lack of staff and other resources as reasons for limitations in enforcement. Without more effective enforcement, the U.S. government is at greater risk of defense items being exported inappropriately.

U.S. government enforcement mechanisms for defense exports are carried out by State and U.S. Customs. State encourages exporters to develop their own compliance programs and to voluntarily disclose when they have violated the exemption.<sup>18</sup> State may direct a company to perform an internal control compliance audit or, if warranted, may seek civil penalties, administrative actions, sanctions, or referrals to the Justice Department. While State oversees these activities, the department primarily depends on U.S. Customs for many enforcement efforts. U.S. Customs, in turn, has various mechanisms to ensure that exporters meet regulatory requirements. For example, U.S. Customs examines export documentation, specifically the Shipper's Export Declaration.<sup>19</sup> U.S. Customs inspectors may perform a physical inspection of an export crossing the border, and its agents investigate potential export violations. In addition, the Department of Justice can prosecute exporters who are suspected of violating export control laws.

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## Limitations in Compliance and Enforcement

We identified a number of limitations for the compliance and enforcement process related to the Canadian exemption.<sup>20</sup> For example, U.S. Customs inspectors are not assured that they are receiving all export declarations as required nor are declarations always complete or accurate when they are submitted. Inspectors at the ports we visited noted that exporters often provide vague descriptions of what they are exporting, which makes

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<sup>18</sup> 22 CFR sec. 127.12.

<sup>19</sup> Exporters are required to submit a Shipper's Export Declaration to U.S. Customs upon exiting a U.S. port and provide copies to State. Sometimes the submission to U.S. Customs is done in advance, since exporters make advance arrangements to ship their goods via sea or air. The U.S. government uses this form to collect export information and compile U.S. trade statistics, as well as to assess export compliance. State has not systematically collected or analyzed information on the declarations to determine compliance.

<sup>20</sup> Some of these limitations also apply to the enforcement process for licensed defense items.

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it difficult to determine whether it is a defense item subject to the Canadian exemption. In addition, we also found that physical inspections on exports are limited. In fact, U.S. Customs officials said that they inspect less than 1 percent of exports.

These limitations are attributed to a lack of information and resources and competing demands within U.S. Customs, which include interdiction of illicit drugs, illegal currency, and stolen vehicles, and since September 11, 2001, terrorism prevention. Of some 7,500 inspectors, about 400 are assigned to export enforcement activities at 301 ports. One port we visited had resorted to “borrowing” port staff from inbound operations inspections to inspect items being exported. Another port had only one person dedicated full time to export activities. When that inspector was not on duty, no one at the port inspected exports.

According to Customs inspectors, staffing limitations make it extremely difficult for them to examine export declarations that cite the Canadian exemption. Inspectors are to perform several time-consuming tasks to ensure proper use of the exemption. For example, inspectors said that they should verify that an exporter is registered with State by querying U.S. Customs’ Automated Export System.<sup>21</sup> They should check whether a company has a record of prior export violations by searching the Treasury Enforcement Communications System database. And they should verify that the item cited on the export declaration is eligible for exemption by reading the International Traffic in Arms Regulations or consulting with the U.S. Customs’ Exodus Command Center. These tasks may be especially difficult to complete at land ports since declarations are presented at the time of crossing.

After the terrorist attacks of September 11, 2001, the U.S. Customs Commissioner stated that terrorism prevention had replaced drug interdiction as the agency’s top priority. U.S. Customs subsequently redeployed nearly 100 inspectors to increase security along the U.S.-Canadian border. On December 10, 2001, a new program called Project Shield America was launched, focused on preventing international terrorist organizations from obtaining sensitive U.S. technology, weapons, and other equipment that could help carry out attacks on America. Some

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<sup>21</sup> The export declaration currently does not require the exporter to provide its registration number, which forces an inspector to take more time to search the database for the name of the company. However, State officials informed us that they are working with U.S. Customs to require the exporter’s registration number on the export declaration.

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inspectors we spoke with said that after the September 11 terrorist attacks, U.S. Customs increased coverage along the northern border by realigning inspectors, temporarily employing National Guardsmen, and increasing inspectors' overtime. However, these inspectors are primarily focused on passengers entering and exiting the country, rather than inspections of defense exports.

U.S. Customs inspectors do not have updated guidance from Customs headquarters that would enable them to conduct inspections effectively. U.S. Customs developed and distributed its primary guidance to inspectors in 1993. This guidance provides an overview of U.S. export laws and regulations, including information on State licensing requirements and a synopsis of the Canadian exemption. U.S. Customs has also recently prepared and distributed a memorandum addressing the May 2001 Canadian exemption requirements. However, the 1993 guidance and the recent memorandum do not discuss inspection techniques for identifying questionable exports. A draft update prepared in 1999 provides some inspection guidance, but it has not been finalized or distributed to inspectors. Some inspectors said that this draft could be useful but had insufficient information when inspecting shipments at land ports.

U.S. Customs headquarters and Justice Department officials told us that it is difficult to investigate and prosecute violations of export control laws. In particular, prosecution of export violations under the exemption are difficult because it is hard to obtain evidence of criminal intent—especially since the government does not always have the documents to demonstrate the violation of the exemption, such as the Shipper's Export Declaration. Even with the documents, some U.S. Customs agents told us that cases involving the Canadian exemption normally involved undercover operations to obtain evidence of criminal intent, and these cases often took a long time to complete.

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## Experience with the Canadian Exemption Could Assist in Ongoing Negotiations

The United States and Canada have had a long history of exporting items under a licensing exemption, and both countries have said the exemption is beneficial for facilitating defense trade and advancing mutual defense. However, when the U.S. government found that some exports under the Canadian exemption were being diverted to countries of concern, the United States and Canada had to come to the negotiating table and reach agreement, making sure that they could balance achieving compatibility of their export control systems with maintaining national sovereignty over export control laws and regulations. Based on the experience with the Canadian exemption, the United States will likely need to address three



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areas when negotiating and executing similar exemptions with other countries.<sup>22</sup> First, upfront agreement is needed on such issues as what items are to be controlled and who can have access to these controlled items. Second, the U.S. government needs to monitor agreements to assess their effectiveness and ensure that unanticipated problems have not arisen. Third, enforcement mechanisms need to be in place to monitor exporters' compliance with the exemption and enable prosecution of violators.

First, countries need upfront agreement on a number of key issues.

- Agreement on what defense items to control. For example, Canada did not control the same defense items that the U.S. government controlled. This included radiation-hardened microelectronic circuits and nuclear weapons design and test equipment, which could be exported from Canada without a Canadian license. Countries need to have the same starting point for controlling items so that enforcement efforts could be concentrated on the same items.
- Agreement on what types of items, including technical data and defense services, could be exported under the exemption. Items excluded from the exemption would require licenses. For example, during the Canadian exemption negotiations, discussions centered on whether Missile Technology Control Regime Items could be exported under the exemption or required a license.
- Agreement on who can have access to controlled articles, technical data, and services, and whether items exported under the exemption can be sent to dual nationals and temporary workers and still be compliant with the laws of both countries. When negotiating the Canadian exemption, this discussion centered on whether dual nationals and temporary workers could have access to U.S.-controlled items and what type of system, such as an exporter registration system, needed to be established to identify who has access to controlled items.

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<sup>22</sup> On May 24, 2000, the U.S. government unveiled 17 proposals known as the Defense Trade Security Initiative, which included a proposal to extend Canadian-like exemptions to qualified countries to facilitate defense cooperation and trade. The U.S. government has since begun negotiations with the United Kingdom and Australia. Further, the Security Assistance Act of 2000 (Pub.L. 106-280, Oct. 6, 2000) requires that exemptions with countries other than Canada be based on legally binding agreements that meet specified requirements and facilitate law enforcement efforts.

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- Resolving conflicts between the export regulations and legal requirements of each country. For example, U.S. law requires that U.S. government approval is needed before controlled items can be re-transferred within a country or re-exported to another country. U.S. government officials said that unauthorized re-exports were the major reason for the negotiations with Canada.
  - The applicability of U.S. export control law to U.S. defense items that are incorporated into products that are made in another country. In the U.S.-Canadian negotiations, discussions centered on how far-reaching U.S. export control requirements are once U.S. items are incorporated in foreign products and then re-exported.

Second, the Canadian exemption experience shows that once agreements have been reached, the U.S. government needs to periodically evaluate the exemption to assess the effectiveness of agreed upon measures and ensure that unanticipated problems do not arise. The U.S. and Canadian governments spent over 2 years negotiating a new exemption and are now working on implementation issues. For example, under new provisions, the Canadian government established a registration system to reduce the risk of transfer to unauthorized individuals and facilitate the Canadian defense industry's access to U.S.-controlled items. Questions remain, however, about how it will be implemented and who needs to be registered. U.S. government officials said that verification of the registrant is key for compliance and enforcement activities.

Finally, enforcement mechanisms need to be in place to ensure export compliance with the exemption. As discussed earlier, U.S. Customs inspectors are not always assured that exporters are submitting required export documentation or that the documentation is complete and accurate, which limits their enforcement efforts. The Department of Justice, in a letter to State, echoed this concern regarding negotiations for additional exemptions and also stated that foreign law enforcement cooperation is needed to provide evidence for successful prosecutions. Resource constraints also create challenges for the law enforcement community. In the end, establishing criteria and lessons learned from current experiences would assist in evaluating whether on-going and future negotiations are successful or if additional issues need to be addressed. State officials acknowledged that there are lessons to be drawn from the Canadian experience.

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## Conclusions

The Canadian exemption relies on exporters to comply voluntarily with export regulations and to disclose when they have not followed those

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regulations. As such, a system of effective checks and balances is needed to maximize the U.S. government's assurance that defense items are being appropriately safeguarded. This includes making sure that exporters have sufficient guidance to enable them to make the right decisions and that exporters, in turn, provide required information to the U.S. government for oversight and enforcement efforts. It also includes making sure that enforcement mechanisms work as effectively as possible.

Extending exemptions to other countries may aggravate problems if the U.S. government does not learn from its experiences. New exemptions may increase the risk of exporters misinterpreting the regulations and create additional opportunities for exporters to inconsistently apply the exemption. In addition, broadening the exemption could further exacerbate enforcement efforts for an already overburdened law enforcement agency. Accordingly, the U.S. government can benefit from the lessons learned from U.S.-Canadian negotiations when extending similar exemptions to other countries.

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## Recommendations for Executive Actions

To enhance the exemption process, we recommend that the secretary of state direct the Office of Defense Trade Controls to review guidance and licensing officer training to improve clarity and ensure consistent application of the exemption. The State Department should also direct the Office of Defense Trade Controls to provide this guidance to U.S. Customs Service for dissemination to field inspectors and agents so that consistent information about the exemption is provided to exporters.

To strengthen enforcement activities, we recommend that the commissioner of the U.S. Customs Service assess the threat of illegal defense exports at all ports along the northern border and evaluate whether reallocation of its inspectors, additional training, or other actions are warranted to augment the capability of inspectors to enforce export regulations. We also recommend that U.S. Customs update, finalize, and disseminate its guidance on defense export inspection requirements to all inspectors.

To facilitate future country exemption negotiations, we recommend that the secretary of state work with the Department of Justice and U.S. Customs Service to assess lessons learned from experience with the Canadian exemption and ensure that these are incorporated in any future agreements.

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## Agency Comments and Our Evaluation

In written comments on a draft of this report, State generally concurred with our assessment that a large part of the compliance and enforcement process under the Canadian exemption relies on the actions of the exporters. In response to our recommendation on guidance and training, State said it will continue its on-going update of its exporter guidance and its training programs. State provided a number of examples of the types of guidance and training it plans to continue to provide exporters on the Canadian exemption. As part of its efforts to update, we believe State should still assess whether its guidance and training are clear and commonly understood by those who need to use them. In concurring with our recommendation on assessing lessons learned, State said it will continue to work closely with U.S. law enforcement agencies to assess lessons from the Canadian exemption to facilitate future country exemption negotiations. However, State did not identify the specific steps it would take to ensure that lessons are actually shared and that knowledge gained will be acted upon in the future. As we stated in our report, enforcement and compliance problems could be exacerbated without full consideration of lessons learned under the Canadian exemption when extending similar exemptions to other countries. State comments are reprinted in appendix IV, along with our evaluation of them.

In its written comments, Customs concurred with our recommendations to (1) assess the threat of illegal exports along the northern border and evaluate whether reallocation of resources and other actions are warranted and (2) update, finalize, and disseminate guidance on defense export inspection requirements. Customs said it will complete these actions no later than December 31, 2002. Customs stated that it conducts yearly threat assessments for the entire country and provides training on various issues, but such activities require a commitment of funds. In addition, Customs stated that we did not address the Automated Export System, which it said has assisted the agency in enforcement efforts. Finally, Customs indicated that lack of manpower and funding for enforcement is problematic for enforcing the Canadian exemption or other defense exports. Customs added that new exemptions for other countries will be increasingly difficult to enforce effectively. We did not include a detailed discussion of the Automated Export System because regulations requiring mandatory filing of export declarations through this system had not been finalized. At the time of our review, most inspectors we contacted were not using the automated system for the majority of enforcement functions related to the Canadian exemption. Customs' comments are reprinted in appendix V.

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## Scope and Methodology

We collected and reviewed selected defense cooperation agreements establishing the special defense relationship between the United States and Canada, developed a regulatory history of the Canadian exemption, and prepared a comparative analysis of the various changes to the Canadian exemption since inception. We also discussed the history and objectives of the exemption with officials at State, the Department of Defense, U.S. and Canadian industry associations, and the Canadian government.

To ascertain how exporters use the exemption, we reviewed the Arms Export Control Act and International Traffic in Arms Regulations to understand the rules governing the U.S.-Canadian exemption process. Because there is no centralized database identifying exporters that use the Canadian exemption, we analyzed State's licensing and registration data for Canada and obtained recommendations from agency officials, industry associations, and others to develop a list of companies that export to Canada. We then selected 12 companies that used the exemption and conducted structured interviews regarding their process and the criteria for exporting under the exemption. These companies represented various small, medium, and large exporters and freight forwarders. We also corroborated information with other U.S. companies and two Canadian industry associations that hosted roundtable discussions for us with 10 Canadian companies.

To determine how U.S. government mechanisms for ensuring compliance with export law and regulations operate, we interviewed State and U.S. Customs officials to obtain explanations about their mechanisms. We reviewed State regulations and briefing materials related to the Canadian exemption and U.S. Customs' draft handbook, standard operating procedures, and training materials. We visited four U.S. Customs ports to observe the inspection process and reviewed seizure case files to determine the nature of noncompliance with the exemption, and another U.S. Customs' port to discuss enforcement issues with officials in the Office of Special Agents in Charge of Investigations. We also interviewed officials at U.S. Customs headquarters in the Office of Field Operations and Special Investigations' Exodus Command Center. We analyzed U.S. Customs' enforcement cases to determine the nature of the noncompliance that led to the change in the April 1999 version of the exemption, along with disclosures of noncompliance with the exemption that were submitted to State by exporters. We also discussed enforcement challenges surrounding the exemption with Justice Department officials.

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To develop observations about future exemption proposals for other countries, we reviewed issues covered in the Canadian exemption negotiation, prior GAO reports on defense trade and export controls, and other documents related to efforts to obtain similar exemptions with other countries. We also asked senior State officials about lessons learned in the Canadian negotiations that may be pertinent for on-going or future negotiations of similar Canadian-like exemptions with other countries.

We requested information and documentation from State related to a number of areas, including the history of the exemption, changes in its scope and reasons for such changes, and issues covered during negotiations that resulted in the May 2001 Canadian exemption. As discussed with your staff, we experienced significant delays in obtaining documents from State. For example, the department took approximately 6 months to provide us with an initial set of 37 documents and an additional 2 months to provide the remaining information that we requested. These delays caused numerous follow-ups with State officials, needlessly occupying time for both State officials and us. More than 90 telephone contacts or E-mails alone pertained to the status of our document request. The delays and lack of State cooperation extended the amount of time needed to respond to this request. We plan to address these issues in a follow-up letter to the secretary of state.

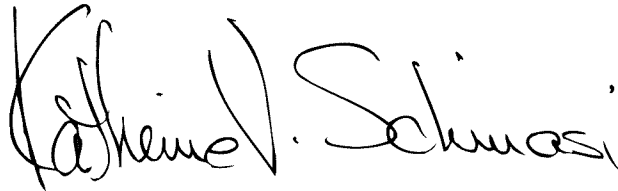
We performed our work between October 2000 and February 2002 in accordance with generally accepted government auditing standards.

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We will send copies of this report to the chairmen and ranking minority members of the Senate Committee on Foreign Relations, the House Committee on International Relations, and the House Committee on Armed Services. We will also send copies to the secretaries of state, defense, treasury, and justice; the commissioner, U.S. Customs Service; and the director, Office of Management and Budget. This report will also be made available on GAO's home page [http: www.gao.gov](http://www.gao.gov).

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If you or your staff have questions concerning this report, please contact me at (202) 512-4841. Others making key contributions to this report are listed in appendix VI.

A handwritten signature in black ink, reading "Katherine V. Schinasi". The signature is fluid and cursive, with the first name "Katherine" and last name "Schinasi" clearly legible, and a middle initial "V." in between.

Katherine V. Schinasi  
Director, Acquisition and Sourcing Management

# Appendix I: Chronology of Selected Defense Cooperation Agreements between the United States and Canada

The United States and Canada have demonstrated their mutual cooperation by entering into more than 2,500 agreements and arrangements over the years. The following are selected defense and economic agreements since 1940.

**Table 1: Chronology of Selected Defense Cooperation Agreements between the United States and Canada**

Year Established	Agreements	Synopsis of Agreements
August 18, 1940	Ogdensburg Declaration	This declaration formed the basis for defense cooperation between the United States and Canada. The Permanent Joint Board on Defense was founded to conduct studies relating to sea, land, and air problems, covering personnel and material, and to consider the defense of the northern half of the Western Hemisphere.
April 20, 1941	Hyde Park Declaration	A joint statement between the U.S. president and Canada’s prime minister agreeing that each country should provide the other with the defense articles it is best able to produce during war mobilization and that each country should coordinate its production programs.
February 12, 1947	U.S./Canada Joint Statement on Defense Cooperation	A joint statement by both countries’ leadership reiterating that the wartime cooperation between the armed forces of the two countries should continue to the extent authorized by law through the postwar period in the interest of efficiency and economy for joint security.
April 12, 1949	Exchange of Notes on the Joint Industrial Mobilization Committee	The notes established the Joint Industrial Mobilization Committee to coordinate each country’s Industrial Mobilization Plans that would effectively use the production facilities of both countries.
September 20, 1950	Statement of Principles for Economic Cooperation	An agreement by the United States and Canada to coordinate the production and resources of both countries to achieve a common defense. Among other things, it required a coordinated program of requirements, production, and procurement between the two countries and instituted coordinated controls over the distribution of scarce raw materials and supplies.
October 1, 1956	Defense Production Sharing Agreement	The agreement was established to achieve greater integration of both countries’ military development and production capabilities while maintaining greater standardization of military equipment, wider dispersal of production facilities, and establishing a supply of supplemental sources. Also, this agreement established that Canadian defense vendors would receive equal and immediate consideration on Department of Defense procurements, just like U.S. vendors, with certain exceptions.
May 12, 1958	North American Aerospace Defense Command Agreement	This agreement established an integrated command in Colorado Springs, Colorado, that centralized operational control of shared air defenses, integrated operational exercises, and maintained individual and collective capacity to resist air attack.
September 14, 1960	Defense Development Sharing Agreement	This agreement was established to allow Canadian firms to perform research and development work for the U.S. military services.
November 21, 1963	Cooperative Development Between the United States Department of Defense and the Canadian Department of Defense Production Memorandum of Understanding	This memorandum established a cooperative program in defense research and development between the U.S. Department of Defense and the Canadian Department of Defence Production. The agreement complements the Defense Production Sharing Program and, among other things, allows Canadian firms to perform research and development work to meet requirements of the U.S. military services and permits the standardization and interchangeability of additional equipment needed for the defense of both countries.



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**Appendix I: Chronology of Selected Defense  
Cooperation Agreements between the United  
States and Canada**

<b>Year Established</b>	<b>Agreements</b>	<b>Synopsis of Agreements</b>
February 1, 1979	Coordination of Cooperative Research and Development Memorandum of Understanding	This memorandum identified the means and opportunities to use the scientific and technical resources to achieve common naval defense interests and made possible the standardization and interoperability of systems and equipment used for the naval defense of the two countries.
March 18, 1985	The Quebec Summit Declaration	A declaration between the prime minister of Canada and the president of the United States regarding international security. Both countries pledged to reduce barriers in defense trade and to establish a freer exchange of technical knowledge and skill in defense production. As a result of this agreement, the North American Defense Industrial Base Organization was created March 23, 1987.
March 23, 1987	Charter for the North American Defense Industrial Base Organization and Letter of Guidance to the Executive Committee	The charter formalized cooperation among Industrial Preparedness Planning activities within the United States and Canada. The organization is designed to ensure that Industrial Preparedness Planning remains a visible and vital element to strengthening the North American defense industrial base.

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# Appendix II: Summary of Enforcement Cases That Supported the Need for Change in the Canadian Exemption

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In April 1999, State revised its regulations to limit the scope of the Canadian exemption after concluding that some exporters misunderstood the exemption and that items were being improperly exported to Canada and re-exported from Canada to unauthorized destinations. State's concerns were supported by a summary of nineteen criminal investigations and seizure cases it identified as related to the Canadian exemption. These cases are summarized below:

1. A major U.S. defense company established a manufacturing facility in Canada and exported defense components, technical data, and technical manuals to this facility under the Canadian exemption. The facility assembled components and prepared complete communication systems for export to Pakistan and provided training for the Pakistani army, without obtaining State-required approval for the exports. State had previously denied the export of such systems to Pakistan because of Congressional prohibitions on such transfers.
2. A Canadian company attempted to sell 35 OH-58 U.S.-origin helicopters to undercover agents posing as brokers for the Iraqi government. These helicopters were to be equipped for air-dispensing chemical weapons. They were seized before being exported from Canada.
3. Fifty-eight M-113 armored vehicles originally sold to the Canadian armed forces were exported without State approval, transferred to Europe, and then to Iran.
4. An Iranian intelligence group established a company in Canada and attempted to acquire U.S. Munitions List controlled klystron tubes, which are specifically used for Hawk missile systems. The U.S. government sought extradition, but was denied. The case was eventually dismissed.
5. A Chinese national established a Canadian company and used the Canadian exemption to acquire a focal plane array-long-range infrared camera. The camera was shipped to China from Canada without State approval. The same individual subsequently ordered an additional 400 cameras. As in the first instance, the Chinese national specified that the Canadian exemption could be used.
6. Another Chinese-owned company established in Canada ordered 400 U.S. Munitions List controlled infrared cameras from a U.S. company and stated that the Canadian exemption should be used, although this would have been an inappropriate use of the exemption.

7. A U.S. company received an order for infrared equipment from a Chinese entity. The U.S. company informed the Chinese buyer that such equipment was controlled on the U.S. Munitions List and restricted from export to China. Upon learning this, the Chinese buyer suggested that the export could take place through a Canadian company under the Canadian exemption and then be re-exported to China.
8. A shipment of 356 U.S. Munitions List controlled turbine engine vanes to be used for military aircraft was seized prior to export. The shipment was destined for an Iranian national, located in Canada, who planned to divert the vanes to Iran.
9. A Canadian company ordered U.S. military fiber optic gyroscopes, stating that the items were to be used in Canada. A government investigation established that the company's owner was a Chinese national, and the gyroscopes, to be obtained using the Canadian exemption, were actually destined for China. Arrests were made and the defendants were eventually convicted.
10. U.S. Munitions List controlled F-18 parts were seized in the United States while in transit from Canada to New Zealand. State had not authorized the re-export.
11. U.S. Munitions List controlled electronic countermeasure equipment was intercepted in the United States when a Canadian company attempted to export this equipment to Malaysia without U.S. export approval.
12. A 3-year investigation uncovered an attempt to ship U.S.-origin items to a subsidiary in Canada and then divert these items to Libya. The items were seized, and an indictment led to a plea agreement.
13. Three U.S. rocket warheads were seized while being shipped from Belgium to Canada. The exporter claimed the Canadian exemption on the export documents, but the exemption did not apply because the shipment was in transit.
14. A Canadian company shipped military vehicles to an Army facility in the United States to test a new classified communications system. After testing, the vehicles were to return to Canada. A Canadian company, rather than the Canadian government, was handling the temporary import of the vehicles. The Canadian company did not seek

or obtain a U.S. export license for moving the vehicles back and forth across the border. It was also learned that this Canadian company had shipped communications equipment, which was eventually intercepted and then seized.

15. U.S. Munitions List controlled gas grenades, projectile guns, and projectiles were seized at the border during an attempt to ship them to Canada while claiming the exemption, rather than under a State-approved license.
16. A shipment of U.S. Munitions List controlled computers and related items were intercepted before being exported to the Sudan. The shipment originated in Canada and was seized when transiting through the United States.
17. U.S.-origin armored vehicle spare parts were intercepted when they were shipped from Canada to the Middle East. The shipment was seized when transiting through the United States without appropriate U.S. export authority.
18. U.S. components for a mobile radar system had originally been exported to Canada under the exemption. The radar was then to be exported to Taiwan under a Canadian license. Since the radar was of U.S. origin, State needed to approve the export to Taiwan. However, State approval was not obtained.
19. A U.S.-origin gas turbine engine had been exported to Sweden and returned to the United States for repair. The engine was then sent to Canada under the Canadian exemption for the actual repair work, although the use of the exemption was inappropriate in this case. The engine was seized on its return to Sweden through the United States.

# Appendix III: Comparison of Recent Changes to the Canadian Exemption—1994, 1999, 2001

The Canadian regulatory exemption is complex and has changed substantially in recent years. The following table highlights changes regarding what is or is not covered under the exemption and reporting or record keeping requirements associated with the exemption.

**Table 2: Comparison of Recent Changes to the Canadian Exemption—1994, 1999, and 2001.**

June 10, 1994	April 12, 1999	May 30, 2001
<b>Export Provisions</b>		
<p>This version of the exemption allowed the export or temporary import of unclassified equipment or technical data without a license under certain circumstances.</p> <p>Exported items had to be used in Canada by Canadian citizens or returned to the United States. For items imported from Canada, the regulation stated that the exemption applied to a “temporary import” that was “...for end-use in the United States or return to Canada to a Canadian citizen...”<sup>a</sup></p>	<p>Language is mostly unchanged from the 1994 version regarding permanent and temporary exports.<sup>b</sup></p>	<p>Language changed to allow <u>all</u> temporary imports from Canada of unclassified defense articles to the United States without a license for temporary use in the United States <u>and</u> return to Canada.</p> <p>Exported items must be used in Canada by Canadian government officials acting in official capacity or by a Canadian registered person or returned to the United States.<sup>c</sup></p>
<b>Exceptions to the Exemption (or Items Requiring Licenses from State)</b>		
<p>Some defense items were not covered by the exemption, requiring a license for export to Canada. These items included:</p> <ul style="list-style-type: none"> <li>Fully automatic firearms and components and parts in Category I (a), which are not for end use by the Canadian federal, provincial, or municipal government.</li> <li>Nuclear weapons, strategic delivery systems, and all components, parts, accessories, and attachments specifically designed for such systems and associated equipment.</li> <li>Nuclear weapon design and test equipment (Category XVI).</li> <li>Naval nuclear propulsion equipment (Category VI (e)).</li> <li>Aircraft, which includes helicopters and drones (Category VIII (a)).</li> <li>Submersible vessels and oceanographic and related equipment, such as swimmer delivery vehicles, designed or modified for military purposes (Category XX (a) through (d)).</li> <li>Defense articles, defense services, or related technical data for use by a foreign national other than a Canadian.</li> <li>Defense services provided under agreements such as manufacturing</li> </ul>	<p>The number of items requiring a license expanded from the 1994 version. Specifically, the following items were added to the list of exceptions to the exemption:</p> <ul style="list-style-type: none"> <li>All Category I – Firearms. This was broadened from the prior version to include all firearms in Category I.</li> <li>Ammunition in Category III for the firearms covered in Category I.</li> <li>Launch vehicles, guided missiles, ballistic missiles, and rockets (Category IV).<sup>e</sup></li> <li>Military information security systems, cryptographic devices, software and components, and stealth (Categories XIII (b) and XIII (j)).</li> <li>Toxicological, chemical, and biological agents and related equipment and radiological equipment (Category XIV (a) through (d)).</li> <li>Spacecraft, remote sensing satellites, and military communications satellites, which includes global positioning systems receiving equipment designed or configured for military use (Category XV (a), (b), and (c)).</li> <li>All classified articles, technical data, and defense services defined in Category XVII, which includes classified articles,</li> </ul>	<p>The following items were added to the 1999 list of exceptions to the exemption:</p> <ul style="list-style-type: none"> <li>All technical data and defense services for gas turbine engine hot sections covered under Category VI (f) and aircraft and military aircraft engines covered under Category VIII (b).</li> <li>Developmental aircraft, engines, and components (Category VIII (f)).</li> <li>All Category XII (c) items such as infrared focal plane array detectors and image intensification and other night-sighting equipment or systems designed, modified, or configured for military use. This, however, excludes any first and second generation image intensification tube and first and second generation image intensification night-sighting equipment.</li> <li>Some radiation hardened microelectronic circuits (Category XV (d)).</li> <li>Certain systems, components, parts, and accessories for space systems and associated equipment (Category XV (e)).</li> <li>Miscellaneous articles, which includes any article that has military applicability not specifically enumerated in other</li> </ul>

**Appendix III: Comparison of Recent Changes  
to the Canadian Exemption—1994, 1999, 2001**

<b>June 10, 1994</b>	<b>April 12, 1999</b>	<b>May 30, 2001</b>
license agreements and technical assistance agreements found in Part 124 of the International Traffic and Arms Regulations. <sup>d</sup>	technical data, and defense services as defined in 120.21 (manufacturing licensing agreements) and 120.8 (defense services). <sup>f</sup> <ul style="list-style-type: none"> <li>All U.S. Munitions list items and related technical data on the Missile Technology Control Regime Annex.</li> </ul>	categories of the U.S. Munitions List (Category XXI).
<b>Defense Items No Longer Requiring a License</b>		
		<p>These items are now permitted under the exemption:</p> <ul style="list-style-type: none"> <li>Launch vehicles, guided and ballistic missiles, and rockets (except when Missile Technology Control Regime items) (Category IV)).</li> <li>Chemical and biological agent detection, identification, and defensive equipment (Certain parts of Category XIV (c)).</li> <li>Commercial Communications Satellites in Category XV (a).</li> <li>GPS-receiving equipment end-items only for export to Canada for use by the Canadian federal government directly or indirectly through a Canadian-registered person (certain parts of Category XV (c)).</li> <li>Military information security systems, and encryption devices (except classified defense articles) (Category XIII (b) and (e)).</li> <li>Limited defense services, including exports of technical data and performance of defense services meeting certain criteria.</li> </ul>
<b>Reporting and Record Keeping Requirements</b>		
<p>The following were the reporting requirements in the 1994 version of the exemption.</p> <ul style="list-style-type: none"> <li>Exporter was required to comply with the requirements under section 123.22 regarding the Shipper's Export Declaration. Specifically, with the exception of unclassified technical data, an exporter was required to file the declaration with U.S. Customs or the postmaster when using an exemption.</li> <li>Defense articles and defense services requiring congressional notification, as stated in parts 123.15 and 124.11 of the International Traffic in Arms Regulations.</li> </ul>	<p>Although elsewhere required in the regulations, the following requirements were explicitly added to the Canadian exemption:</p> <ul style="list-style-type: none"> <li>The exporter must be registered as an exporter or manufacturer of defense articles with State and meet certain eligibility requirements, which includes requiring the exporter to be a U.S. person.</li> <li>The exporter must obtain written documentation that (i) the defense article is for end use in Canada by a Canadian citizen, and (ii) prior U.S. government approval will be obtained when the article is used by non-Canadians, in Canada, or exported from Canada to another foreign destination.</li> <li>For all defense articles identified as significant military equipment on the U.S.</li> </ul>	<p>The 2001 version of the exemption contains the same requirements as previous versions, with the following changes.</p> <ul style="list-style-type: none"> <li>Re-export/retransfer of U.S. Munitions List items to another user in Canada or from Canada to another country requires prior approval from State. This section also discusses who is responsible for obtaining such approval.<sup>g</sup></li> <li>A note discusses a requirement to obtain a license when the exporter knows the defense article is not being exported to a qualified Canadian registered person and provides additional exemptions that are also applicable to Canada.</li> </ul>

**Appendix III: Comparison of Recent Changes  
to the Canadian Exemption—1994, 1999, 2001**

June 10, 1994	April 12, 1999	May 30, 2001
	<p>Munitions List, the exporter must obtain a non-transfer and use certificate.</p> <ul style="list-style-type: none"> <li>Records related to these exports are to be maintained for five years.</li> <li>A note to the exemption covered the exporter's responsibilities for obtaining in writing that the Canadian end user and end use are legitimate. It stated that if such written documentation is not available, the exemption may not be used.</li> </ul>	

<sup>a</sup> The reference to end use of a temporary import in the United States was confusing. Apparently, the regulations should have permitted the end-use in the United States and return to Canada.

<sup>b</sup> This version of the regulations continued to confusingly refer to temporary imports for end-use in the United States.

<sup>c</sup> For the purpose of the Canadian exemption, a Canadian registered person is any Canadian national (including Canadian business entities organized under the laws of Canada), dual national, and permanent resident registered in Canada in accordance with the Canadian Defense Production Act, and such other Canadian Crown Corporations as may be identified by State.

<sup>d</sup> A manufacturing license agreement is an agreement in which a U.S. person grants a foreign person an authorization to manufacture defense articles abroad and involves or contemplates use and/or export of technical data. A technical assistance agreement is for performance of defense services or for the disclosure of technical data, as opposed to an agreement granting a right or license to manufacture defense articles.

<sup>e</sup> Certain items like bombs, grenades, torpedoes, depth charges, and land and naval mines were excluded from this license requirement.

<sup>f</sup> We noted that section 120.8 of the regulations refers to major defense equipment. Defense services are covered in section 120.9 of the regulations.

<sup>g</sup> Although elsewhere required in the regulations, this requirement was explicitly added to the Canadian exemption.

# Appendix IV: Comments from the U.S. Department of State

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



United States Department of State

Washington, D.C. 20520

MAR 20 2002

Dear Ms. Westin:

We appreciate the opportunity to review your draft report, "DEFENSE TRADE: Lessons to Be Learned from the Country Export Exemption," GAO-02-63, GAO Job Code 120046.

The enclosed Department of State comments are provided for incorporation with this letter as an appendix to the final report.

If you have any questions concerning this response, please contact Peter Berry, Chief, Arms Licensing Division, Bureau of Political-Military Affairs, at (202) 663-2806.

Sincerely,

A handwritten signature in black ink, appearing to read "James L. Millette".

James L. Millette, Acting  
Assistant Secretary and  
Chief Financial Officer

Enclosure:

As stated.

cc: GAO/ASM - Ms. Katherine V. Schinasi  
State/OIG - Mr. Berman  
State/PM - Mr. Maggi

Ms. Susan S. Westin,  
Managing Director,  
International Affairs and Trade,  
U.S. General Accounting Office.



Department of State Comments on GAO Draft Report

DEFENSE TRADE: Lessons to Be Learned from the Country  
Export Exemption  
(GAO-02-63, GAO Code 120046)

State Department comments on this draft report are set forth below in detail. As always, Department officers are prepared to discuss and elaborate on these comments in person at any time.

GENERAL COMMENTS

The Department generally agrees with GAO's observation that:

"Although an item may be exempt from State [licensing] review and approval, it is still subject to U.S. export control law. Under an exemption, the burden for reviewing the legitimacy of the transaction shifts from State to the exporter. Therefore, a large part of the compliance and enforcement process under the Canadian exemption relies on the actions of exporters."

Exports under such exemptions receive little government scrutiny prior to the export. It is the nature of export license exemptions that greater responsibility resides in the hands of the exporter. The allowances and limitations of the Canadian ITAR exemption are delineated in detail in section 126.5 of the regulations, and the U.S. Government reasonably expects U.S. exporters that utilize the exemption to adhere to the provisions of that regulation.

Exporters that seek to transfer defense articles to Canada retain the option to apply for a license in the usual manner, though most, if their export is eligible for the licensing exemption, will export license-free. If exporters are uncertain as to whether their proposed export is eligible for the licensing exemption, they may seek an advisory opinion from DTC in accordance with established procedures.

While describing in the present tense what it terms as inconsistent implementation of the Canadian ITAR exemption by exporters, GAO seems to be recounting exporter behavior

See comment 1.

- 2 -

in the 1999 timeframe. While it is possible that inconsistencies in implementation may still occur from time to time, it is the Department's understanding that the examples cited by GAO occurred in 1999 and 2000. The chronology is important because the exemption was subsequently revised to address areas, such as technical data, where the current Canadian ITAR exemption requires an export license for technical data when part of an offshore procurement.

**Inconsistent implementation:** One of the opening lines in the GAO report is that "exporters are implementing the Canadian exemption inconsistently." This is not surprising. Exporters are not required to use the Canadian export exemption when eligible. As GAO states, certain commodities "are being exported using the exemption by some exporters while others are applying for licenses." DTC does not consider such inconsistency a negative development as long as the export utilizing the exemption meets the requirements of the ITAR.

See comment 2.

If some exporters for their own business operations or internal compliance reasons wish to apply for a license even when technically qualified to use the exemption, we believe they ought not be discouraged. This situation should be distinguished from other situations where exporters might use the licensing exemption inappropriately (knowingly or not) or where experience with the exemption will lead to more regular use in the future.

**Ensuring compliance is difficult:** While compliance with the ITAR is left in the hands of the exporter during the implementation of a licensing exemption, the U.S. Customs Service has jurisdiction in the case of criminal violations of the AECA and ITAR and also has exclusive jurisdiction generally at U.S. ports of exit. Since the government does not review use of the license exemption until the exporter delivers the out-bound shipment to the port, it is very important that the exporter provide the required paperwork to Customs at, or prior to the time of export.

In the case of exports under the authority of a licensing exemption, Customs is the first and last government agency to review the prospective export. It is therefore imperative that Customs demand that for each export, all required documentation, such as the Shipper's

- 3 -

Export Declaration, be provided with enough detail to adequately describe the export articles. The Canadian exemption does not make the export to Canada exempt from documentation requirements, and Customs should deny exit of any shipment that is not properly documented.

GAO noted that State has an important role to play assisting Customs by responding to inquiries on the applicability of the ITAR exemption for particular exports, but said that "at times, we found that State provided inconsistent answers" when responding to inquiries.

At the request of USCS, responses to these referrals need to be swift because they usually involve the detention of a shipment of goods at the port, potentially resulting in storage, shipping, and contract costs for the exporter while the goods remain in detention. In such cases, and particularly those in which incomplete information is provided, the advice tendered by DTC officers does not represent a formal determination as to USML coverage, but the best advice immediately available based on the information submitted. (In this regard, DTC receives about 1,500 referrals from USCS each year for immediate attention.)

See comment 3.

Exporters who may believe the commodity has been mischaracterized or not fully understood in the USCS referral process are free, and encouraged when appropriate, to pursue formal determinations through the commodity jurisdiction procedure. Implementation of the Automated Export Service (AES) should provide a future basis upon which computer tracking of precedent cases by Exodus will reduce the prospects for inconsistent determinations, a problem whose dimensions appear to be modest in any case.

See comment 4.

See comment 5.

**RECOMMENDATION:** State should review and clarify exporter guidance and licensing officer training. State should also provide this guidance to Customs for dissemination to field inspectors and agents.

State will continue its ongoing update of its exporter guidance and its training programs.

See comment 6.

When the Canadian exemption was added as an amendment to the ITAR, DTC conducted training seminars throughout Canada so that Canadian trade firms would know how the new exemption would operate. DTC continues to provide

- 4 -

information and guidance to the exporting public on the Canadian ITAR exemption through information on the DTC Internet website, periodic exporter outreach programs held at DTC, and regular DTC participation in seminars organized by export industry groups. Customs Service officers receive ITAR training from DTC personnel during periodic training held across the country. DTC also holds weekly training sessions for its licensing officers on various export control topics, and recently the session was devoted to the Canadian ITAR exemption. The specific Qs and As appearing on DTC's web site on use of the Canadian exemption were fashioned through an extensive outreach program involving the U.S. defense industry and led by the Department's private sector federal advisory committee, the Defense Trade Advisory Group.

**RECOMMENDATION:** State should work with Justice and Customs to assess lessons learned from the Canadian exemption to facilitate future country exemption negotiations.

State will continue to work closely with U.S. law enforcement agencies with this objective in mind.

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The following are GAO's comments on the Department of State's letter dated March 20, 2002.

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## GAO Comments

1. We clarified text to identify when inconsistencies occurred for the export of technical data under the exemption for offshore procurement activities. We added an example to our report showing that some exporters are unclear about when to export technical data and defense services under the May 2001 revision to the Canadian exemption.
2. State indicated that it did not discourage exporters from applying for licenses when the exemption can be used. Such a practice results in State's already scarce resources having to process additional licenses. In addition, some exporters may be at a competitive disadvantage because they are applying for a license when others may be using the exemption when exporting the same item.
3. State said that the advice it provides to Customs through the referral process does not represent a formal State determination. According to Customs guidance and a Customs headquarters official, Customs considers State's input as a formal determination and not advice. A decision from State is critical because it may result in a seizure of the export.
4. As State noted, responses to referrals need to be made quickly when items are detained at the port. State further indicated that exporters who believe the commodity has been mischaracterized or not fully understood are encouraged to pursue formal determination through the commodity jurisdiction process. However, the commodity jurisdiction process is time-consuming. Therefore, determinations made through the commodity jurisdiction process would not resolve the need to make quick determinations through the referral process.
5. We did not include a detailed discussion on the Automated Export System because regulations requiring mandatory filing of export declarations through this system had not been finalized at the time of our review.
6. Based on discussions with State officials, we added information to the report on State's training and outreach efforts.

# Appendix V: Comments from the U.S. Customs Service



## U.S. Customs Service

### *Memorandum*

DATE: **March 14, 2002**

FILE: AUD-1-OP SM

MEMORANDUM FOR KATHERINE V. SCHINASI  
GENERAL ACCOUNTING OFFICE

FROM: Director, Office of Planning

SUBJECT: Draft Audit Report on Canadian Export Exemption

Thank you for providing us with a copy of your draft report entitled "Defense Trade: Lessons to Be Learned from the Country Export Exemption" and the opportunity to discuss the issues in this report. We believe that most of our concerns have been addressed through discussions with the audit team.

U.S. Customs currently conducts a yearly threat assessment for the entire country for various threats, including the threat of illegal defense exports. Additionally, U.S. Customs provides training on Exodus, seaport and land border Outbound issues. To improve enforcement and reduce the threat of illegal defense exports to either Canada or anywhere else in the world requires a commitment of funds to the U.S. Customs Service dedicated to Outbound enforcement.

The report did not address any aspect of the Automated Export System or how it is impacting the enforcement of the Canadian exemption. The Automated Export System becomes a major component when regulations are finalized for the mandatory electronic filing of Shipper's Export Declarations data for U.S. Munitions List (USML) and Commerce Control List (CCL) commodities. There is no mention that this electronic system was designed for statistical data collection for the Bureau of the Census. U.S. Customs has been able to adapt the system to assist in enforcement efforts. However, it is not currently capable of performing all the enforcement functions required for the efficient and effective enforcement of the ITAR. Additionally, there is no funding available to make the necessary programming changes for currently identified improvements.

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-2-

Based on the lack of manpower and funding for improved enforcement in the automated environment, overall enforcement of the new Canadian ITAR exemption or any other ITAR license or exemption becomes problematic at best. New exemptions for Australia, United Kingdom, and other countries will prove to be increasingly difficult to effectively enforce except on a spot basis. U.S. Munitions List commodities will be exported in violation of the International Traffic in Arms Regulations both willfully and by oversight on the part of U.S. exporters.

We concur with the recommendations stated in the report and will complete the actions cited below not later than December 31, 2002.

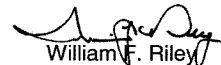
**Recommendation 1:** The Commissioner of the U.S. Customs Service assess the threat of illegal defense exports at all ports along the northern border and evaluate whether reallocation of its inspectors, additional training or other actions are warranted to augment the capability of the inspectors to enforce export regulations.

**Management Comments:** We will review current threat assessment to determine the need for reallocation of inspectional resources.

**Recommendation 2:** The U.S. Customs Service should update, finalize, and disseminate its guidance on defense export inspections requirements to all inspectors.

**Management Comments:** Customs will update and finalize the Exodus Handbook.

Once again, thank you for the opportunity to comment on the draft report. If you have any questions, please have a member of your staff contact Ms. Sandy Manuel at (202) 927-2096.

  
William F. Riley

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# Appendix VI: GAO Contact and Staff Acknowledgments

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## GAO Contact

Anne-Marie Lasowski, (202) 512-4146

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## Acknowledgments

Marion Gatling, Lillian Slodkowski, Delores Cohen, Ian Ferguson, Bob Swierczek, and John Van Schaik also made significant contributions to this report.



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# GAO Products on Defense Trade and Export Controls

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*Export Controls: Reengineering Business Processes Can Improve Efficiency of State Department License Reviews.* GAO-02-203. Washington, D.C.: December 31, 2001.

*Export Controls: Clarification of Jurisdiction for Missile Technology Items Needed.* GAO-02-120. Washington, D.C.: October 9, 2001.

*Defense Trade: Information on U.S. Weapons Deliveries to the Middle East* GAO-01-1078. Washington, D.C.: September 21, 2001.

*Export Controls: State and Commerce Department License Review Times are Similar.* GAO-01-528. Washington, D.C.: June 1, 2001.

*Export Controls: Regulatory Change Needed to Comply with Missile Technology Licensing Requirements.* GAO-01-530. Washington, D.C.: May 31, 2001.

*Foreign Military Sales: Changes Needed to Correct Weaknesses in End-Use Monitoring Program.* GAO/NSIAD-00-208. Washington, D.C.: August 24, 2000.

*Defense Trade: Status of the Department of Defense's Initiatives on Defense Cooperation.* GAO/NSIAD-00-190R. Washington, D.C.: July 19, 2000.

*Defense Trade: Analysis of Support for Recent Initiatives.* GAO/NSIAD-00-191. Washington, D.C.: August 31, 2000.

*Defense Trade: Identifying Foreign Acquisitions Affecting National Security Can Be Improved.* GAO/NSIAD-00-144. Washington, D.C.: June 29, 2000.

*Foreign Military Sales: Efforts to Improve Administration Hampered by Insufficient Information.* GAO/NSIAD-00-37. Washington, D.C.: November 22, 1999.

*Foreign Military Sales: Review Process for Controlled Missile Technology Needs Improvement.* GAO/NSIAD-99-231. Washington, D.C.: September 29, 1999.

*Defense Trade: Department of Defense Savings From Export Sales Are Difficult to Capture.* GAO/NSIAD-99-191. Washington, D.C.: September 17, 1999.

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GAO/ NSIAD-99-8. Washington, D.C.: November 13, 1998.

*Defense Trade: Status of the Defense Export Loan Guarantee Program.*  
GAO/ NSIAD-99-30. Washington, D.C.: December 21, 1998.

*Defense Trade: Observations on Issues Concerning Offsets.*  
GAO-01-278T. Washington, D.C.: December 15, 2000.

*Defense Trade: Data Collection and Coordination on Offsets.*  
GAO-01-83R. Washington, D.C.: October 26, 2000.

*Defense Trade: U.S. Contractors Employ Diverse Activities to Meet Offset Obligations.* GAO/NSIAD-99-35. Washington, D.C.: December 18, 1998.

*Defense Trade: Contractors Engage in Varied International Alliances.*  
GAO/NSIAD-00-213. Washington, D.C.: September 7, 2000.

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